B A S I S

Broadening Access and Strengthening Input Market Systems

Financial Sector Development and Agrarian Reform in Kyrgyzstan and Uzbekistan: An Overview and Recommendations for Research Themes and Methods

BASIS CRSP
Central Asia Research Planning Workshop

Tashkent, Uzbekistan
January 26-29, 1998

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Sources

This report is based on:

- field work carried out directly by the author in Uzbekistan;
- previous CARMA work carried out by Geetha Nagarajan in Uzbekistan
- a July, 1997, Asian Development Report on the rural financial sector in Kyrgyzstan;
- and the BASIS CRSP Central Asia Research Planning Workshop held in Tashkent, Uzbekistan, January 26-29, 1998.

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I. Overview: The Rural Financial Sector in Uzbekistan

The Setting. The condition of the rural financial sector is of concern because a majority (61%) of the Uzbek population resides in rural areas and nearly half (46%) of the total Uzbek population is employed in agriculture. The financial service needs of the rural population are largely unmet; banks in 1996 were able to supply only 18% (SUMs 9 billion) of the estimated S50 billion demand for agricultural sector credit. The demand for savings instruments is also unmet. Capital is used by the rural population to finance machinery, feed, fertilizer, seed, fuel, and plants, among other farming and production inputs. Actual and potential users of savings and credit services include collective farms, private independent farmers, lease-hold farmers, private farmers' associations, collectives, private agro-processing firms, private traders, commodity and input associations, households, and small and medium private businesses (agro-based and other).

Formal Financial Institutions & Programs. Following independence, a two-tier banking system was created in 1991: (1) a central bank, the National Bank of Uzbekistan and (2) several specialized banks to service public, state, and private enterprises. Table 1 outlines the formal financial institutions that currently exist:

Table 1: Formal Financial Institutions in Uzbekistan as of November 1997
(Adapted from Nagarajan (1997))

Type	#	Role	Ownership	Comments
Central Bank	1	Prudential regulation and supervision of banks; monetary & foreign exchange policies.	State	No annual reports providing consolidated balance sheets, bank rates, or banking policies. A TA team is placed in the bank to strengthen quality and reliability of reports that subscribe to international standards. Also, a USAID consultant is providing TA for prudential regulation and supervision of banks.
Foreign Exchange Bank	1		State	NBU
Savings Bank	1	Interbank lender	State	
Agricultural Banks	4	Lends government-directed credit to state-owned commodity associations which, in turn, provide advance payments to farmers (who thereby contract to sell produce to same commodity association at a fixed price).	State	
(1) Paktha Bank (cotton)				1996 bad debts: 80% of loans outstanding
(2) Galla Bank (wheat)				
(3) Mevasabsavot Bank (fruits & vegetables)				
(4) Turon Bank (irrigation)				
Tadbirkor Bank (Industrial Bank)	1	Lends gov't funds for farm & agro-processing machinery.	State	June 1997 arrears: 42% of loans outstanding
Commercial Banks	15		State, state-enterprises, few private shareholders	Only 1 of the 15 is relevant to the agricultural sector, providing mortgage loans.

Foreign-Owned Banks	5		Foreign	

The four agricultural banks, the industrial bank and one commercial bank (that provides mortgage loans) supply 90% of agricultural sector loans and represent the largest banks in the country both in terms of asset size and loan portfolio. As shown in Table 2, State-owned banks are supported by special fund programs and supporting institutions:

Table 2: Special Fund Programs and Supporting Institutions
(Adapted from Nagarajan (1997))

Program/Institution	**Features/Comments**
Business Development Funds (BDF)	Established 1995 by Presidential Decree. Directed subsidized credit available through BDF regional offices for small and medium private businesses including agro-based businesses. Loan rates: 15-35% per annum. Terms: 6 months - 10 years. Ag loans charged on low end. Jan. 1997, 2,300 loans of C2.82 million.
Central Asian-American Enterprise Fund	Administered by Asian Crossroads Loan Company. Tadbikor (industrial) Bank has entered into a joint venture to provide medium-term loans (up to 3 years) in foreign currency to small and medium enterprises to purchase fixed assets.
Commodity & Input Associations	Have monopoly rights to supply inputs to farmers as well as purchase farmer outputs. Have exclusive access to subsidized government funds channeled through major banks. Facilitate channeling of government funds from banks to farmers and collection of loan payments.
Insurance Companies	Insure banks and commodity associations against risks of default, property damage, and crop failure. 3 of 40 domestic and foreign insurance companies insure bank loans made to agricultural sector: (1) Madad Insurance Company, established by Presidential Decree in 1995, insures BDF; (2) Uzagrosugurta Insurance Company was formed by Presidential Decree in 1997 to insure banks and commodity associations against defaults on loans and advance payments made to farmers. Bank Sugurta formed in 1996 with majority ownership by Association of Bankers insures collateral property offered to banks and provides life insurance to borrowers. These insurance companies are not regulated to insure that they operate safely and soundly and they are reported to have limited knowledge of the agricultural sector and private farmers to effectively insure loans.

Non-Bank Financial Schemes and Informal Financial Intermediation. Non-bank financial schemes and informal financial intermediation is limited to a couple of small-scale experimental activities and traditional informal strategies. These include:

- <u>Revolving Loan Fund</u>. Mercy Corps International is the sole NGO actively providing grants and loans to farmers and small and medium entrepreneurs. The primary objective of Mercy Corps' financial program is to enable private farmers to accumulate fixed assets so as to reduce farmer dependence on collectives for machinery and inputs. Clients which include private independent farmers, lease-hold farmers, private farmers' associations, and private agro-processing firms, are required to produce business plans for loans ranging in size from US$1,000-10,000. Interest is 5% per month. The repayment rate is reportedly 98%.
- <u>Credit Union Promotion</u>. In addition to Mercy Corps' revolving fund

program, a team of international NGOs (World Council of Credit Unions, Winrock International, Mercy Corps) and the Business Women's Association (BWA) of Uzbekistan have collaborated in preliminary efforts to promote and organize six credit unions in several areas of the country. Key constraints to the further development of credit unions include: (1) confirmation that existing legislation allows credit union formation, registration, savings mobilization and loan granting; (2) financial management and training for credit union leaders and staff; and (3) a framework to insure the prudential operation of credit unions in the absence of a regulatory and supervisory framework.

An encouraging recent development is that in late January 1998, the Cabinet of Ministers asked the BWA to work with the Ministry of Finance and the Central Bank to draft a Presidential Decree allowing credit union development. Through support from the International Executive Service Corps (IESC) and USAID, BWA retained World Council of Credit Unions in February 1998 to assist in (a) drafting a letter to the Cabinet of Ministers outlining elements of a decree and (b) identifying necessary conditions for safe and sound credit union development.

- <u>RoSCAs</u>. "Eigilish" or "Black Cash" Rotating Savings and Credit Associations have become widespread following the Soviet era when they were illegal. Participants are usually women, in average group sizes of 20, who belong to a Koran reading club or who are members of a collective. A responsible and trusted leader collects dues, allocates pots, and enforces timely payments. Monthly member contributions of approximately C1,000 per month are collected in pots allocated according to member requests. Typical uses are to pay for a son's dowry, buy jewelry for a daughter's wedding, and clothing and gifts for Ramadan.

- <u>Friends and Relatives</u>. Financial transactions among friends and family appear to be limited. Loans tend to be small, interest-free, and short-term. Tapped for small working capital requirements, friends and family are apparently not considered a major source to finance purchase of fixed assets. [These observations are based on a small sampling and should be investigated further before drawing any conclusions.]

- <u>Trader Finance</u>. Traders in bazaars provide trusted customers will small, short-term, in-kind loans. Traders also engage in financial transactions among themselves.

- <u>Self-Finance</u>. Farmer households save both in financial and non-financial form to finance purchases of fixed assets. Women often keep their savings on their person and/or save in goods that will retain their value in an inflationary environment.

Summary Characteristics of Rural Financial Markets and Constraints to the Development of a Viable Rural Financial System. The characteristics of Uzbek rural financial markets that have a "chilling effect" on the development of a viable rural financial system can be summarized as follows:

- supply-led credit
- negative real rates on loans and savings
- interest rate restrictions
- inability to cover transactions costs (government-determined margins)
- conduits for government funds to targeted clientele
- arrears (enterprises)
- susceptible to aggregate ag risk
- little diversification
- inflation
- monetization constraints/tight money supply
- non-competitive credit access
- restrictions on migration
- disincentives to save
- perception of government funds as grants

II. Overview: The Rural Financial Sector in Kyrgyzstan

The Setting. Kyrgyzstan is predominantly rural with over 60% of the population residing in rural areas. Since independence, the Government of Kyrgyzstan has been steadily implementing a program of agricultural sector reforms. However, there have been ongoing difficulties with independence and the transition to market-based institutions; consequently, agricultural producers have tended to retreat from commercial production to subsistence operations and barter exchange. The rural sector has been entirely dependent on system banks for banking services and an estimated 73% of the country's population is without full banking services.

Formal Financial Institutions. After independence, the National Bank of the Kyrgyz Republic was established in June, 1991, and was followed by the introduction of a two-tier banking system in May 1993. Initially, four system banks dominated the financial system: Agroprombank, Elbank, AKB Kyrgyzstan, and Promstroibank. Agroprombank and Elbank have since been liquidated after collapsing under the burden of massive debt and inappropriate interest rate structures. Positively, there are a number of profitable private banks including Maksat, Kurulush, Alniyet, Mercury, and Kramds banks; but these banks and the two remaining system banks have reduced their operations in rural areas and are reluctant to service rural clients because of perceived high risk, high administration costs, and difficulty of communications with rural areas.

Non-Bank Financial Schemes and Informal Financial Intermediation. Credit cooperatives were formed under a November, 1995, Presidential Decree to serve as a conduit for channeling in-kind assistance to farmers; these cooperatives offer no deposit mobilization facility. In 1995, the nonbanking financial sector included several hundred currency exchange shops, more than 30 insurance companies, 24 investment funds, 18 pension funds, and a stock exchange. Only 5 percent of households and 2 percent of nonfarm enterprises have loans from informal finance sources. Of 140 farms surveyed by an ADB team, no households interviewed had loans from moneylenders. There appears to be no significant informal financing of trade.

Characteristics of Rural Financial Markets and Constraints to the Development of a Viable Rural Financial System. The Kyrgyz financial sector is hampered by:

- a low level of bank capitalization
- inadequate risk management
- inadequate loan loss provisioning
- low deposit growth with most liquidity remaining outside the banking system
- an inadequate accounting system
- inadequate training of bank staff
- inappropriate banking practices that serve as a disincentive for using banks
- lack of public confidence in the formal financial system
- lack of customer-service orientation
- lack of understanding credit as a contract requiring repayment

Despite indications that substantial savings exist throughout the country, these savings are not being deposited in banks and are not circulating in the economy. There is, thus, a complete absence of financial intermediation in rural areas.

Critical Issues Facing the Government. A key policy concern of the Government is rebuilding the financial sector, including access by the rural population to financial services. Two critical issues are (a) the need for emergency seasonal credit in the intermediate term and (b) the need to develop an efficient rural financial system in the medium and long term. Government policy is clear to avoid the proliferation of project-dependent credit schemes and rely on banks and other financial institutions for rural financial intermediation.

III. Recommendations for Research Themes and Methods

Two foci for research themes are recommended:

(1) Access to personal financial services:
- (a) savings and credit
- (b) formal vs. informal vs. semi-formal
- (c) cash vs. non-cash
- (d) barriers to financial intermediation

(2) Constraints to financial sector development:
   (a) barriers to financial intermediation
   (b) legislative framework/enabling legislation
   (c) regulatory framework/guidelines
   (d) supervisory responsibility and capacity

The overall recommended method is to look at local level activity and the external environment to recommend policy reform at the national government level and experimental activities at the local government level.

A Note on Uzbekistan. Bearing in mind the Government's "step-by-step approach," BASIS CRSP will first want to understand the problems of how to increase competition, create a level playing field, allow market-based pricing, and eliminate unnecessary costs. In addition, the role of government merits review; as the country privatizes, government's role will evolve as a regulator and monitor.

Under the BASIS framework, R1 and R2 are particularly relevant:

R1: Sequencing market liberalization and development
R2: Market organization and support under privatization and agrarian reform

In earlier CARMA work, Geetha Nagarajan queries whether privatization of input and output markets will improve land, labor, and financial markets; whether improved access to finance by private input and output traders will broaden access to input and finance on the part of ag sector clients; whether breaking the monopoly of commodity associations will improve the farming community's access to inputs and long-term finance from alternative sources and improve rural income. Beyond these general queries, the key is to identify the bottlenecks that prevent privatization of input and output markets, improved access to financial services, and breaking up of monopolies. That is, what are the vested interests that constrain the Government of Uzbekistan (GOU) and how can constraints be addressed within GOU's step-by-step approach to market reform? The GOU has conflicting interests: on the one hand, it needs to assure itself of government revenues; on the other hand, the GOU is concerned about the welfare of its largely agrarian population. What is needed is a "step-by-step" approach that assures that *both* of the government's interests can be met. The State needs to be able to move away from reliance on direct revenue from economic activities to indirect tax revenue through which State can provide incentives for desirable activities and disincentives for undesirable behavior. Ultimately, the Government must evolve to assume the roles of regulator, monitor, enabler, watchdog, and tax collector, protecting the interests of the people, land, other natural resources, financial resources.

IV. Suggested Data Tables

The following data tables are the result of a working session held on February 2, 1998 with Uzbek BASIS participants following the January workshop. An asterisk * indicates an afterthought of the consultant author's.

A.. Macro-economic information 1991, 1992, 1993, 1994, 1995, 1996, 1997? (Year-end, Monthly, Average for the year)

1. Inflation or Consumer Price Index
2. Foreign Exchange Rate (Sum/Dollar)
3.* Population
4.* Population that is economically active
5.* Population that is rural
6.* Population that rural and economically active

B. For each bank: consolidated financial statements, audited (if possible), for fiscal years ending 1991, 1992, 1993, 1994, 1995, 1996, 1997?

1. Assets/Liabilities
2. Income/Expense Statements
3. Cash Flow Reports
4. Delinquency (Past Due) Reports (30 days, 90 days, 1 year)

C. For each bank: FY ending 1991, 1992, 1993, 1994, 1995, 1996, 1997?

1. For each savings instrument:
   - a. type
   - b. interest rate
   - c. term
   - d. minimum amount, if any
   - e. restrictions on withdrawals
   - f. volume (amount in Sums)

2. For each credit instrument:
   - a. type of loan
   - b. interest rate
   - c. term
   - d. information required by banks in loan application
   - d. volume (amount in Sums)
   - e. delinquency (past due amounts

3. # of savers

4. # of borrowers

D. Aggregate Information for all banks 1991, 1992, 1993, 1994, 1995, 1996, 1997?
   1. # of savers
   2. # of borrowers
   3. savings
   4. loans
   5. reserves
   6. assets

E. Other Information
   1. Delayed payment for inter-enterprise debt
   2. Any available data on Business Development Funds (BDF) and Central Asian-American Enterprise Fund (e.g., fund size, loan distribution (by type of loan and/or agriculture vs. non-ag), term, interest rate, total loans granted, current loans outstanding, repayment rate)
   3. Government agricultural subsidies budget (credit and non-credit)
   4. Insurance Companies (amount of claims for bad loans)

F. Miscellaneous Points
   1. Data points will be one of three categories
      a. Available
      b. Not available (collected but not public)
      c. Not collected
   2. Central Bank figures will not necessarily match IMF data because of Central Bank accounting practices and non-availability of some data for public or external use)
   3. Data is to be collected at national level and oblast level (UZ: Andijan, Fergana, Namangan; KR: Osh), if available

V. A "Quick & Dirty" Checklist of Points and Questions for Financial Law Review

A review of laws impacting on financial sector markets emerged as an immediate need. A "quick and dirty" checklist of points and questions might include the following:

A. What types of bank, non-bank financial institutions, and informal/semi-formal entities are allowed to (1) collect deposits, (2) issue credit, or (3) both collect deposits and issue loans?

B. By type of financial institution:
-Registration requirements.
-Regulatory body/bodies responsible for setting prudential standards.
-What prudential standards must be met?

-What other standards must be met?
-Sanctions for not meeting prudential or other standards.
-Body/bodies responsible for supervising financial institutions.
-Other roles and responsibilities of government body/bodies.
-Allowable activities:
  -Loans. Types of loans (types, sizes, terms, restrictions)
  -Savings and deposit instruments (amounts, withdrawals, restrictions)
  -Savings amounts
  -Investments
  -Sources of loanable funds
  -Client profile (savers, borrowers, restrictions)
  -Funds transfer
  -Fees
-Pricing: Interest rates on loans
-Pricing: Interest rates on savings
-Internal controls
-Liability for losses

VI. A Comprehensive Checklist of Points and Questions for Financial Law Review

A more comprehensive checklist of points and questions for financial law review follows:

A. Legal authority:
Title (name) and effective date of applicable Presidential Decrees, laws, regulations, other legal documents for each type of financial institution and allowable non-bank financial intermediation. Distinguishing characteristics of each type of bank and non-bank financial institution.

B. Registration:
Procedures and criteria for registration of each type of bank and non-bank financial institutions. Allowed jurisdiction(s) of operations. Accepted fiscal year.

C. Powers:
1. General powers that each type of financial institution is authorized to exercise as generally accepted corporate powers; e.g.,
   a. acquire, lease, hold, assign, pledge, mortgage, discount, dispose of property or assets.
   b. enter into contracts
   c. institute and defend lawsuits
   d. borrow funds (up to what amount?)

e. accept deposits
f. provide loans
g. incidental powers

2. Other powers specific to each institution's purpose and concerning relationships that may be established with other entities; e.g.,
   a. purchase of assets of other financial institutions
   b. allowed membership in bank or non-bank associations
   c. serve as fiscal agent for and receive payments on deposits from a governmental body
   d. collect, receive, disburse monies in connection with providing cash transactions, negotiable checks, money orders, travelers checks, other money instruments
   e. act as trustee and accept and hold in trust real and personal property
   f. act as trustee or custodian of any form of deferred income accounts (e.g., retirement, pension, profit-sharing, severance)
   g. purchase or make available various forms of insurance on individual or group basis.

D. <u>Ownership/Shareholding</u>

For each type of financial institution:
1. Eligibility of owners/shareholders
2. Procedure for becoming an owner/shareholder
3. Conditions under which an owner/shareholder can be removed
4. Liability of owners/shareholders for financial institutions' debt
5. General meeting of owners/shareholders

E. <u>Clientele</u>

For each type of financial institution:
1. Eligible clientele
2. Procedure for becoming a client
3. Conditions under which a client can be terminated
4. Liability of clientele

F. <u>Management and Administration</u>

For each type of financial institution:
1. Authority and responsibilities of board of directors
2. Executive officers, terms, authority
3. Internal Controls
   a. Internal body, if any, that administers lending functions
   b. Internal body, if any, that examines and reviews the affairs of the financial institution to assure their integrity
4. External audit requirements

5. Authorization to hire chief operating officer and employees
6. Handling of conflicts of interest; prohibitions to ensure that officials of financial institutions do not use their positions for personal advantage.
7. Requirements/authorization to obtain
    a. fidelity bond for any officials responsible for funds or property
    b. insurance coverage to protect officials who have acted honestly and in good faith from liability incurred in official capacities.

G. Deposits

For each type of financial institution:

1. Forms of allowable deposits; e.g.,
    a. term deposits maturing at a fixed date
    b. notice deposits withdrawable upon giving notice of a set number of days
    c. demand deposits payable to third parties as checking accounts
    d. regular savings/passbook/current accounts with no maturity date).
2. Terms, rates, and conditions: What are limitations and allowances and by whom are they established.
3. Representation in balance sheets. Should be a liability (i.e., claim on an institution's assets).
4. Interest rate on deposits: Determined by whom and what; e.g.,
    a. minimum balance
    b. term requirements
    c. prevailing market rates of interest
    d. institution's ability to pay
5. Withdrawals: Conditions under which withdrawal of deposits may be made; limitations.
6. Joint accounts?
7. Trust accounts? (Account held in trust in a financial institution by one person for the benefit of another person.)
8. Charges against deposits: Collection of debts owed to a financial institution by drawing upon any account or other funds the debtor may have in the financial institution.
9. Dormant accounts: Means for a financial institution to dispose of accounts inactive for extended periods of time.

H. Loans

For each type of financial institution:

1. The purpose and conditions for which loans can be granted
2. Loan limits and security--guidelines on acceptable forms of security

and overall restriction on loans to any one client (% of assets)

3. Interest and other charges:
    a. Authorization to set interest rates subject to general statutory or regulatory limits.
    b. Fees associated with making, closing, disbursing, extending, collecting, or renewing of loans. Authority to assess charges for failure to pay loans in manner agreed.
    c. Authorized refunds of interest
4. Loan application procedure: Requirement of written documentation for every loan.
5. Non-conventional forms of lending; e.g.,
    a. Line of credit
    b. Guaranteed government loan program
6. Loans to officials of financial institutions: Prevention of conflicts of interest by placing special approval requirements on loans

I. <u>Investment of Funds</u>:

For each type of financial institution:

1. Power of each financial institution to invest accumulated funds that are not on loan to clients
2. Broad categories of authorized investments; limits on investments
3. Means for meeting day-to-day cash demands
4. Where accumulated funds may be kept
5. Limits on investment in fixed assets (non-earning); e.g., structures, land, furnishings
6. Requirements to maintain a portion of assets in liquid form

J. <u>Reserves and Allowances</u>

For each type of financial institution:

Reserves required to provide financial stability by maintaining capital level to cover possible losses from loans, investments, and other contingencies.

1. Required reserve formula: Amount (e.g., 10%) of total risk assets for which general reserves must be held from gross income; amount (e.g., 10%) of gross income that must be transferred to general reserves until 10% of total risk assets is met.
2. Limits on use of general reserve.
3. Definition of risk assets as used in reserve formula; e.g., loans and long-term investments (maturities of 12 or more months).

4. Allowance for loan loss:
    a. Do accounting principles permit loan loss allowance?
    b. Level (%) of required allowance for possible losses on delinquent loans.
    c. Separate from general reserves?

K. <u>Associations for Financial Institutions</u>

For each type of financial institution:

1. Provision allowing formation of secondary support system.
2. Programs and services of such secondary support systems.

L. <u>Central Financial Liquidity System</u>

For each type of financial institution:

1. Provision or authorization for formation of central financial liquidity system to provide liquidity to a system of financial institutions.
2. Powers and privileges of central financial liquidity entity.
3. Prohibited activities (e.g., serving natural persons and financial institutions outside the system).
4. General reserve formula.

M. <u>Stabilization</u>

For each type of financial institution:

1. How the system deals with risk of insolvency.
2. Purpose and establishment of a stabilization fund.
3. Representative body to control and administer stabilization fund.
4. Powers and principle measures stabilization fund may take to accomplish its purposes.
5. Sources of funds for the stabilization fund. What percentage of deposits or other appropriate basis will participating financial institutions contribute to the stabilization fund and/or be levied?)

N. <u>Supervision and Regulation</u>

For each type of financial institution:

1. Designation of government agency that registers and supervises the financial institution).
2. Purpose of the government inspection process or examination (e.g., to review the soundness of management affecting liquidity and solvency of the financial institution.
3. Provision of personnel to administer the government agency.
4. Routine regulatory powers of the government superintendent such as issuance of regulations, required reports, and periodic inspections.
    a. Reporting requirements: frequency, by when, what information
    b. Inspections: frequency, completed by whom, what inspected
5. Enforcement powers of the superintendent to compel regulatory compliance such as restrictions on accounts, cease and desist orders, suspension, removal of officials, fines or penalties, civil or criminal action.

6. Authority of superintendent to place a financial institution under special supervision when it fails to institute directed remedial measures or remains in violation of the law.
7. Purview of the superintendent to take possession and control of a financial institution and designate an administrator to manage its affairs for a period time.
8. Authority to place an insolvent financial institution into involuntary liquidation. Plus: suspension, notice of impending action, opportunity for hearing.
9. Appeals process or review board to which aggrieved financial institutions and their officials may appeal decisions of the superintendent. I.e., safeguards for a financial institution and its leadership against arbitrary or unreasonable actions by the government regulator. Plus: composition of review board--Does it give due weight to both the government position and that of the financial institution and provide for a neutral party?